Final Code Sec. 367(a) and (d) Regulations

The IRS and Treasury recently issued final regulations under Code Sec. 367(a) and (d) that make a monumental change in how those provisions have applied since they were enacted over 30 years ago.[1] For the first time, the regulations subject to taxation the otherwise tax free transfer of foreign goodwill and going concern value by a domestic corporation to a foreign subsidiary for use in a trade or business outside the United States.[2]

Code Sec. 367(a) provides generally that gain on the otherwise tax free transfer of property by a U.S. person to a foreign corporation is subject to taxation. A broad general exception is provided for the transfer of "any" property for use in the active conduct of a trade or business outside the United States, with a limited list of ineligible items (*e.g.,* inventory and Code Sec. 936(h)(3)(B) intangible property).

The final regulations essentially abandon the Code's general active trade or business exception. They generally require that gain be recognized under Code Sec. 367(a) on the transfer of any property to a foreign corporation for use in a trade or business outside the United States.[3] A limited carve-out is provided for "eligible property," which is defined as tangible property, working interests in oil or gas property and certain financial assets.[4]

Code Sec. 367(a) does not apply to intangible property within the meaning of Code Sec. 936(h)(3)(B); rather, Code Sec. 367(d) applies. That section treats an otherwise tax free transfer of such intangible property by a domestic corporation to a foreign corporation as a sale for a stream of annual payments contingent on productivity and includible in the transferor's income over the useful life of the intangible property.

Code Sec. 936(h)(3)(B) defines intangible property by providing a list of 28 items, including patents, designs, copyrights, trademarks, franchises, contracts, systems, programs and customer lists. The definition ends by including "any similar item" and providing that all included items, whether specifically enumerated or merely "similar," must have "substantial value independent of the services of any individual."

The list of intangible property subject to Code Sec. 367(d) does not include goodwill or going concern value,[5] and the Tax Court, rejecting the IRS's contrary assertion, held that goodwill, going concern value and workforce in place are not included in Code Sec. 936(h)(3)(B) as "similar" items.[6] Prior regulations in effect since 1984 stated that Code Sec. 367(d) "shall not apply to the transfer of foreign goodwill or going concern value."[7] Therefore, gain on the transfer of foreign goodwill and going concern value to a foreign subsidiary generally was not taxable under Code Sec. 367 under the active trade or business exception.

In contrast, under the final regulations, gain on the transfer of foreign goodwill and going concern value is taxable because these items are not included in the narrow list of items qualifying for the active trade or business exception to Code Sec. 367(a). While the regulations remove the exception from Code Sec. 367(d) for foreign goodwill and going concern value, they do not purport to include those items within the definition of intangible property subject to Code Sec. 367(d), *i.e.,* that section still applies only to intangible property within the meaning of Code Sec. 936(h)(3)(B). The regulations do, however, permit a taxpayer to apply the rules of Code Sec. 367(d) (rather than Code Sec. 367(a)) to other intangible property, such as goodwill and going concern value.[8]

LOWELL D. YODER is a Partner in the Chicago office of McDermott Will & Emery LLP, and Global Head of Tax.

As numerous comment letters demonstrated, these regulations depart from the Code and Congressional intent. Code Sec. 367(a) provides a general exception for transfers of **any** property for use in an active trade or business outside the United States, and the list of ineligible items does not include goodwill or going concern value. Congress adopted a specific definition of ineligible intangible property which does not include goodwill or going concern value (the final regulations remove this statutory reference as no longer necessary). The intent to exclude foreign goodwill and going concern value from taxation under Code Sec. 367 is unequivocally expressed in the legislative history as reflected in temporary regulations for over 30 years.[9]

Indeed, the IRS and Treasury apparently continue to believe that it generally would be appropriate for foreign goodwill and going concern value to not be subject to taxation under Code Sec. 367, but state that taxing such items is necessary because taxpayers are taking positions that an inappropriately large portion of the value of property transferred to a foreign subsidiary consists of goodwill and going concern value rather than Code Sec. 936(h)(3)(B) intangible property.[10] The government, however, does not support its assertion,[11] and the Tax Court has rejected similar IRS transfer pricing arguments (but the preamble nowhere discusses those cases). The final regulations appear to be essentially an attempt to bolster the IRS's litigation position.[12]

Code Sec. 367 applies only to transfers of property, and the final regulations do not attempt to overrule well-established case law that holds that merely relocating functions within a multinational group, or allowing an affiliate to benefit from a business opportunity available to the group, does not result in a taxable transfer, where the function relocation or opportunity does not take the form of any legally enforceable rights.[13] The section 482 regulations confirm that such benefits in and of themselves are not compensable under Code Sec. 482.[14] In addition, the Tax Court recently confirmed that the IRS must demonstrate affirmatively that taxable asset transfers occurred, rather than simply asking the court to infer that such must be the case in light of the putative transferee's subsequent earning of an entrepreneurial profit.[15]

ENDNOTES

1 T.D. 9803, 81 FR 91,012 (Dec. 16, 2016). The final regulations purport to apply retroactively to transfers occurring on or after September 14, 2015. Reg. §1.367(a)-1(g)(5).

2 The final regulations adopt proposed regulations with no material changes. *See* REG-139483-13, 80 FR 55,568 (Sept. 16, 2015); Yoder, *Proposed Code Sec. 367 Regs Attempt to Tax Foreign Goodwill and Going Concern Value*, INT'L TAX J. 3 (March–April 2016).

3 Reg. §1.367(a)-2(a)(2).

4 Reg. §1.367(a)-2(b).

5 Other definitions of intangible property specifically list goodwill and going concern value in situations in which policy makers have intended for a rule to apply to these items. *See, e.g.,* Code Secs. 197(d) and 865(d); Reg. §1.263(a)-4(c)(1)(ix)–(x); Reg. §1.954-2(e)(3)(iv); Reg. §1.861-9T(h)(1)(ii).

6 *Veritas Software Corp.,* 133 TC 297, 316, 323, Dec. 58,016 (2009). *See* Yoder & Lewis, *Properly Valuing Intangibles Transferred to Foreign Subsidiaries*, 142 TAX NOTES 470 (2014).

7 Reg. §1.367(d)-1T(b).

8 Reg. §1.367(a)-1(b)(5), (d)(5).

9 *See, e.g.,* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Dec. 31, 1984), at 428 ("Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax.").

10 Preamble to Proposed Regulations, 80 FR, at 55,571–55,572; Preamble to Final Regulations, 81 FR, at 91,105–91,116.

11 *See* Letter to Editor, *Response to Treasury's Crackdown on Goodwill Boom*, 150 TAX NOTES 367 (Jan. 18, 2016) (illustrates that goodwill can represent a majority of the value of a business).

12 The validity of the final regulations seems questionable. *See Altera Corp.*, 145 TC No. 3 (July 27, 2015) (unanimous reviewed Tax Court opinion held that Reg. §1.482-7(d)(2) was invalid because the Treasury failed to demonstrate that it engage in reasoned decision-making as required by the Administrative Procedure Act). The IRS has appealed this decision to the U.S. Court of Appeals for the Ninth Circuit, Docket Nos. 16-70496, 16-70497.

13 *See Hospital Corp. of America*, 81 TC 520, 590, Dec. 40,476 (1983) (no compensation was required for the mere act of making available to a foreign subsidiary an opportunity to construct and run a hospital in Saudi Arabia, as the opportunity entailed no legally enforceable property rights); *Bausch & Lomb, Inc.*, 92 TC 525, Dec. 45,547 (1989), *aff'd,* CA-2, 91-1 USTC ¶50,244, 933 F2d 1084 ("The mere power to determine who in a controlled group will earn income cannot justify a section 482 allocation of the income from the entity who actually earned the income."); *Merck & Co., Inc.*, 91-2 USTC ¶50,456, 24 ClsCt 73, 88 (The court stated that the arrangement involved "no more than a recognition that Merck is the parent of the foreign affiliates. A parent corporation may create subsidiaries and determine which among its subsidiaries will earn income. The mere power to determine who in a controlled group will earn income cannot justify a section 482 allocation from the entity that actually earned the income.").

14 Reg. §1.482-9(l)(3)(v) ("[a] controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group"); (l)(5), *Exs.* 15, 18 and 19.

15 *See Medtronic, Inc.*, 111 TCM 1515, Dec. 60,627(M), TC Memo. 2016-112 (June 9, 2016), at 141–142 ("[T]he gist of respondent's argument seems to be that MPROC could not possibly be as profitable as it is unless intangibles were transferred to it. We are not persuaded by this argument."). Similarly, in a Stipulation of Settled Issues filed with the Tax Court on July 20, 2016, in *Guidant LLC*, the IRS fully conceded its arguments under section 367(a) and (d), despite the fact that the resolution of the ongoing transfer pricing issues as stipulated left more return offshore than the IRS had contended was consistent with the arm's-length standard.